Boston College Law Review

Volume 11
Issue 3 *Number 3* Article 6

3-1-1970

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Recommended Citation

Roger P. Kirman, *A Comparison of Insider Liability under Diamond v. Oreamuno and Federal Securities Law*, 11 B.C.L. Rev. 499 (1970), http://lawdigitalcommons.bc.edu/bclr/vol11/iss3/6

A COMPARISON OF INSIDER LIABILITY UNDER *DIAMOND v. OREAMUNO* AND FEDERAL SECURITIES LAW

The use of information not generally available to the public by corporate officers and directors in their personal transactions in the securities of their corporation is generally regulated by federal statute.[1] In *Diamond v. Oreamuno*[2] however, the New York Court of Appeals sustained, on the basis of agency law, a shareholder's derivative complaint brought to recover the profits realized by the president and the chairman of the board of directors from the sale of securities of their corporation transacted on the basis of nonpublic information.[3] This comment will analyze the cause of action recognized in *Diamond* and compare it with the federal cause of action created by Section 16(b) of the Securities Exchange Act of 1934[4] to determine which action provides the more effective approach for a potential plaintiff.

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1 The Securities Exchange Act of 1934 § 10b, 15 U.S.C. § 78j (1964), provides in part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or any facility of any national securities exchange—
>
> (a) . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Pursuant to the above authorization the Securities Exchange Commission established rule 10b-5, 17 C.F.R. § 240.10b-5 (1969), which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

2 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

3 Throughout this comment the terms confidential information, inside information, nondisclosed information, and nonpublic information are used interchangeably to denote knowledge of facts or circumstances other than what is considered general business knowledge.

4 The Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1964), provides in part:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months . . . .

The proper party to bring a rule 10b-5[5] action in cases such as *Diamond* will be identified, and the possibility of the defendants' double or triple liability under *Diamond*, section 16(b) and rule 10b-5 will be evaluated.

I. The Agency Theory

In *Diamond* the president and the chairman of the board of directors of Management Assistance, Inc. (MAI) sold 56,500 shares of MAI stock on the basis of their knowledge that the earnings of MAI for August, 1966, had decreased sharply in comparison with MAI's earnings for the previous month,[6] and in comparison with earnings for the same month in the previous year.[7] The sale occurred before the decrease in corporate earnings was publicly disclosed. A shareholder filed a derivative suit to recover for the corporation the profits derived by the defendants from the sale of stock.[8]

The plaintiff-shareholder argued that the private use of confidential information by officers or directors having access to the information solely by virtue of their positions with the corporation is a breach of their fiduciary duty to the corporation. It was further contended by plaintiff that the defendants learned of the information in the course of their corporate duties and that they were entrusted with the potentially valuable information for the sole purpose of carrying on the corporate business. The plaintiff argued that the defendants breached their fiduciary duty when they appropriated the information for their personal benefit. Their fiduciary duty required that they act solely in the interest of the corporation with regard to their use of corporate assets. The New York Supreme Court dismissed the complaint for failure to state a cause of action.[9] The appellate division reversed the lower court[10] and the decision of the appellate division was affirmed by the Court of Appeals of New York.[11]

The holding of the court of appeals in *Diamond* is based exclusively on principles of agency law.[12] The court found that the defendants were agents of the corporation and had learned of the

5 See note 1 supra.

6 24 N.Y.2d at 497, 248 N.E.2d at 911, 301 N.Y.S.2d at 80.

7 Diamond v. Oreamuno, 29 App. Div. 2d 285, 286, 287 N.Y.S.2d 300, 302 (1968).

8 The defendants received $28 per share of stock. The market price of the stock fell to $11 per share after the information was disclosed several months later. 24 N.Y.2d at 497, 248 N.E.2d at 912, 301 N.Y.S.2d at 80. The difference between the price per share that the defendants received and the price they would have realized had the information been disclosed, arguably $17 per share, is the profit the corporation is seeking to recover.

9 Judge Gold's decision was not reported.

10 29 App. Div. 2d 285, 287 N.Y.S.2d 300 (1968).

11 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

12 The court based its opinion on a prior New York agency case, Byrne v. Barrett, 268 N.Y. 199, 197 N.E. 217 (1935), and the Restatement (Second) of Agency § 388, comment *c* (1957).

decrease in earnings in the course of their corporate duties. The court held that an agent entrusted with information for the purpose of carrying on his principal's business may use the information for that purpose only. An agent who exploits, for his own benefit, knowledge or information acquired by virtue of a fiduciary relationship must account to his principal for any profits he derives therefrom.[13] Thus, in rejecting the defendants' arguments that injury to the corporation must be shown, the court held that an agent deriving profits from the personal use of such information must account for them to the corporation, even though the personal use of the information causes no damage to the principal.[14]

The court noted that damage or injury to the corporation as a result of the defendants' activities could be inferred. The use of non-public information in securities transactions by corporate officers or directors casts a cloud upon the reputation of the corporation, undermines shareholder relations, destroys public confidence in the securities of the corporation and generally diminishes the prestige and good will of the corporation.[15] The court, however, held that injury is not a necessary element to a cause of action based upon breach of a fiduciary duty. The court reasoned that the purpose of such a cause of action is not merely to provide compensation to an injured party but to deter agents from attempting to derive personal profits from the private use of corporate information by eliminating the profit incentive for such breaches of fiduciary duty.[16] The court observed that the primary concern in such a case is not to determine whether the corporation suffered injury but, as between the defendants and the corporation, who has the higher claim to the profits derived from the exploitation of the corporate asset.[17]

The *Diamond* decision has been strongly criticized by at least two other commentators.[18] Their analyses suggest that the case represents an undesirable departure from prior New York case law and that the section of the Restatement (Second) of Agency[19] which was heavily relied on by the court is an over-generalization and is unsupported by the cases cited in connection with that section.[20] Further-

13 24 N.Y.2d at 497, 248 N.E.2d at 912, 301 N.Y.S.2d at 80.

14 Id. at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 80.

15 Id. at 494, 248 N.E.2d at 912-13, 301 N.Y.S.2d at 82.

16 Id. at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 81.

17 Id.

18 18 Buffalo L. Rev. 193 (1968); 37 Fordham L. Rev. 477 (1968).

19 The Restatement (Second) of Agency § 388, comment *c* (1957) states in part:

> An agent who acquires confidential information in the course of his employment or in violation of his duties has a duty . . . to account for any profits made by the use of such information, although this does not harm the principal. . . . So, if . . . [a corporate officer] has "inside" information that the corporation is about to purchase or sell securities, or to declare or to pass a dividend, profits made by him in stock transactions undertaken because of his knowledge are held in constructive trust for the principal.

20 One commentator further suggested that public policv does not require the estab-

more, it can be argued that the court should have considered the rationale of decisions in other jurisdictions which have denied liability in fact situations similar to *Diamond.*

Prior to *Diamond* the limitations placed upon the personal activities of corporate officers and directors by their fiduciary obligations were never considered by the New York courts to be as broad as the *Diamond* holding suggests. Officers and directors have been held accountable for the profits they derived from usurping a corporate opportunity. For example, in *Averill v. Barber*[21] the defendant directors had purchased for themselves patents which their corporation required for it operations. The defendants were held accountable to the corporation for the patents and all profits realized from their use.

Officers and directors also have been held accountable for all the profits they derived from personal transactions in which they used a corporate asset or property. For example, in *Marcus v. Otis*[22] directors were held accountable for the profits derived from the purchase of stock in another corporation because they had used corporate funds, which were later repaid, to finance the purchase. Similarly, officers and directors have been prohibited from engaging in activities which are in competition which is detrimental to the corporation. In *Foley v. D'Agostino*[23] the defendants were directors and 50 percent shareholders in several related close family corporations which operated supermarkets under the family name. The court held that the defendants were prohibited from independently operating a rival and competing chain of supermarkets even though the family corporations had turned down the opportunity to purchase the rival chain from its previous owner. The court said that officers and directors may not engage in competing businesses to the detriment of their corporation. Furthermore, officers and directors have been held accountable for profits they derive from transactions entered into on behalf of their corporation where the transactions cause direct injury to the corporation. In *Garden Hill Estates, Inc. v. Bernstein,*[24] the president of a corporation was held accountable to his corporation for the "kickbacks" he received from a contractor. Officers or directors also may be held liable for any excessive profits they derive from the sale of a controlling interest in their corporation.[25]

These prior New York cases, many of which involved the use of inside information by corporate officers and directors, all have an additional element. None of these cases support the proposition that

lishment of the cause of action recognized in *Diamond* since the defendants incur liability under federal securities law and thus their misconduct will not be unchecked. 37 Fordham L. Rev. 477, 480 (1968).

21 53 Hun 636, 6 N.Y.S. 255 (N.Y. Sup. Ct. 1889).

22 168 F.2d 649 (2d Cir. 1948).

23 21 App. Div. 2d 60, 248 N.Y.S.2d 121 (1964).

24 24 App. Div. 2d 512, 261 N.Y.S.2d 648 (1965).

25 Perlman v. Feldman, 219 F.2d 173 (2d Cir. 1955), cert. denied, 349 U.S. 952 (1955).

the use of inside information is per se a breach of fiduciary duty. Rather, they hold that the particular manner in which the information is used gives rise to the breach of fiduciary duty, such as where use of the information amounts to a usurpation of a corporate opportunity or results in competition with the corporation.

The court in *Diamond* based its holding in part on *Byrne v. Barrett.*[26] In *Byrne,* however, the defendant agent, in utilizing the information acquired in the course of his agency, was acting in direct competition with his principal. The defendant's actions amounted to a diversion of a business opportunity.[27] Thus, the case is in line with the prior New York cases which hold that an agent may not use information acquired in the course of his agency in personal transactions which result in competition detrimental to his principal. *Byrne,* however, does not support the position that any use of such information is per se a breach of the agent's fiduciary duty, and, to that extent, does not support the holding in *Diamond. Byrne* is distinguishable from *Diamond* in that the defendants in *Diamond* did not appropriate a corporate opportunity or compete with the corporation. It would have been illegal under federal securities law for the corporation to sell its shares on the basis of the inside information.[28] Thus, the defendants' actions can not be construed as diverting a corporate opportunity or competing with the corporation since the corporation itself was prohibited from engaging in the transaction.

Furthermore, the court did not consider the positions of several courts in other jurisdictions which have held, contrary to *Diamond,* that an officer or director who uses inside information for his own benefit does not breach his fiduciary duty when the activities engaged in by the officer or director are ultra vires to the corporation.[29] In *Diedrick v. Helm*[30] a loan association required as part of its loan agreements that borrowers carry insurance on their property in favor of the association. The association was prohibited from engaging in the insurance business, or receiving commissions on policies covering property against which it loaned money, according to its by-laws and a state statute as construed by the Commissioner of Banks. A director of the association was independently engaged in the insurance business and his insurance office was located within the offices of the associa-

[26] 268 N.Y. 199, 197 N.E. 217 (1935).

[27] In *Byrne* an agent resigned from his position as salesman for a real estate broker during the time he was negotiating the sale of a leasehold. While he was an agent he had misinformed his principal as to the likelihood of the success of the transaction. Following his resignation, the former agent successfully completed the negotiations on his own behalf. Id. at 204-05, 197 N.E. at 217-18. Thus, although the defendant used information acquired in the course of his agency, his actions amounted to a diversion of a business opportunity of his principal.

[28] Kohler v. Kohler Co., 319 F.2d 634, 638 (7th Cir. 1963).

[29] Annot., 153 A.L.R. 663 (1944) and cases cited therein. The term ulta vires is used in its broadest sense, i.e., to denote activities which are improper for the corporation to engage in either because such actions are not authorized by the corporate charter or by-laws or, as in the present case, the actions are otherwise illegal.

[30] 217 Minn. 483, 14 N.W.2d 913 (1944).

tion. The director used his knowledge of applicants of the association as a source of clients for his insurance business. The Minnesota Supreme Court held that the profits derived from the use of that information were not accountable to the association. The court reasoned that the association had no interest, expectancy or opportunity to derive profits from the sale of insurance to its clients, and that the director could appropriate the information to sell insurance without incurring any liability to the association.[31]

Another court reached a similar result in *Thilco Timber Co. v. Sawyer*.[32] There, two directors of a corporation were engaged in the business of buying tax titles to property. They purchased the tax title to property of which their corporation and another party were co-tenants. The corporation was legally prohibited from purchasing the tax title to property of which it was a co-tenant.[33] The directors learned of the tax sale in the course of their corporate duties but the Supreme Court of Michigan held that they could make personal use of the information without incurring any liability to their corporation. Contrary to the holding in *Diamond*, it was held that an officer or director does not per se breach his fiduciary duty if he appropriates for his own use information acquired in the course of his duties.[34]

The *Diamond* decision has also been criticized for its reliance on comment *c* of Section 388 of the Restatement (Second) of Agency.[35] Although the comment, cited by the court,[36] directly supports its holding, the cases cited in connection with the section do not fully support the broad generalization stated in the comment. The cases cited in connection with section 388 involve a variety of situations in which an agent derived personal profit from a transaction which he undertook on behalf of his principal. In *Savage v. Mayer*,[37] an agent who had represented the cost of securities he purchased for his principal to be greater than they actually were, was held account-

31 Id. at 499, 14 N.W.2d at 922.

32 236 Mich. 401, 210 N.W. 204 (1926).

33 Id. at 404, 210 N.W. at 205.

34 In Young v. Columbia Oil Co., 110 W. Va. 364, 158 S.E. 678 (1931), the corporation was engaged in the business of drilling for oil and gas. The directors of the corporation were informed by the United States Land Department that a corporation or a person could only purchase one 20-acre tract in an area in which the corporation sought to explore for oil. In light of this limitation the directors each purchased one 20-acre tract for themselves as well as one 20-acre tract for the corporation. The court required the directors to account to the other shareholders for the profits they derived from their tracts. The court stated that the directors had a duty to make full disclosure of the information to the shareholders so that they might have the opportunity to apply for those lands themselves. The court stated that the defendants' rights as directors were no greater than the other shareholders'. *Diamond* is distinguishable in that the defendants' transactions were illegal, and thus the shareholders would have had no opportunity to sell their shares if they were told of the inside information and the public was not.

35 37 Fordham L. Rev. 477, 479 (1968). See note 19 supra for text of comment *c*.

36 24 N.Y.2d at 501, 248 N.E.2d at 914, 301 N.Y.S.2d at 83.

37 33 Cal. 2d 548, 203 P.2d 9 (1949).

able for the excess amount he had charged his principal. Similarly, in *Blackburn's Adm'x v. Union Bank & Trust Co.*,[38] an agent of a bank who charged borrowers a service charge for examining titles and preparing mortgages in the name of the bank and retained the profits for himself, was held accountable to the bank for the profits he realized. These cases involve situations in which an agent made personal profits, other than salary or commissions paid by the principal, on transactions conducted by the agent on behalf of his principal. They are thus distinguishable from *Diamond* where the defendants were not engaged in transactions on behalf of the corporation, and they do not support the broad statement of comment *c* that an agent must account for profits derived by him from any use of confidential information.

Although the court did not refer to Section 395 of the Restatement,[39] that section is cited in comment *c* of section 388. Section 395 contains the same prohibition stated in comment *c* with regard to an agent's duty to account for profits he derives from the personal use of confidential information acquired in the course of his agency. However, the cases cited in connection with section 395 also do not support the broad generalization made by the Restatement. In *Fairchild Engine & Airplane Corp. v. Cox*,[40] an agent was prohibited from disclosing his former employer's secret process to a competitor. And in *Shell Petroleum Corp. v. Pratt*,[41] a geologist was held to have breached his fiduciary duty when he purchased an interest in lands which he had evaluated for the company. In *Junker v. Plummer*,[42] former employees were prohibited from duplicating their employer's unique machinery and using it for their own advantage and to the harm of their past employer. In these cases the finding of a breach of fiduciary duty is based upon more than the fact that the agent used confidential information. In each case the use of the information constituted competition with the principal or usurpation of a business opportunity or caused injury to the principal. The cases do not support the position that any use of confidential information is per se a breach of fiduciary duty. The Restatement's position must be considered to be an over-generalization.

Even though the broad holding of *Diamond* that an officer or director per se breaches his fiduciary duty by the use of confidential information acquired in the course of his duties is in error, it is submitted that the result reached by the court is correct. It is suggested

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38 269 Ky. 699, 108 S.W.2d 806 (1937).

39 The Restatement (Second) of Agency § 395 (1957) states in part:

> [A]n agent is subject to a duty to the principal not to use or communicate information . . . acquired by him during the course of or on account of his agency . . . on his own account or on behalf of another. . . .

40 50 N.Y.S.2d 643 (Sup. Ct. 1944).

41 22 F. Supp. 304 (D.C. Kan. 1938), aff'd, 100 F.2d 833 (10th Cir. 1938), cert. denied, 306 U.S. 659 (1938).

42 320 Mass. 76, 67 N.E.2d 667 (1946).

that the defendants in *Diamond* breached their fiduciary duties, and thus are liable for their profits, by placing their personal interests in conflict with the interests of their corporation.[43] When the defendants, on the basis of nonpublic information, sold securities of their corporation, they were acting in their own interests for their own benefit. Defendants' activities created at least potential if not actual injury to the corporation.[44] The court implicitly recognized this conflict of interest when it stated that it could be inferred that the defendants' transactions resulted in injury to the reputation, good will and image of the corporation.[45] It was the particular manner in which the defendants in *Diamond* used the information which created the conflict between the defendants' financial interests and the interest of the corporation. This conflict of interest, created by the potential for injury to the corporation, constituted the defendants' breach of their fiduciary duty.

Diamond is distinguishable from the *Thilco* line of cases cited earlier in which the courts held that corporate officers and directors do not breach their fiduciary duty when they appropriate inside information for their own use if the manner in which the information is used is ultra vires to the corporation. *Diamond* may be distinguished because there the use of the information by the defendants created a conflict of interest and the possibility of injury to the corporation, and because the actions of the officer and director were otherwise illegal and generally contrary to the public policy favoring fair competition in the securities marketplace.[46] It is the illegality of the defendants' actions in *Diamond*, a factor not present in the *Thilco* line of cases, with the resulting adverse impact upon the corporation of which defendants were president and chairman of the board of directors, that created the conflict of interest. The defendants' activities in the *Thilco* line of cases were not otherwise illegal or contrary to public policy, and therefore there was no adverse effect on their corporation and no conflict of interest. Thus, in situations such as *Diamond*, officers and directors breach their fiduciary duty when they use inside information in an illegal manner for personal profit because they at least risk (if not cause) injury to their corporation. Therefore, as the court stated, the profits they derive from those

[43] "The fundamental question in each case is whether the officer or director of a corporation has permitted his self-interest to conflict with the interests of the corporation." Diedrick v. Helm, 217 Minn. 483, 494, 14 N.W.2d 913, 919 (1944).

[44] The injuries which the *Diamond* court called inferable can necessarily only accrue when the defendants' transactions have been made public and not before then.

[45] 24 N.Y.2d at 499, 248 N.E.2d at 912-13, 301 N.Y.S.2d at 81-82.

[46] The Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1964), provides in part:

> For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are effected with a national public interest which makes it necessary to provide for regulation and control . . . to insure the maintenance of fair and honest markets in such transactions. . . .

transactions should be accountable to the corporation as the best means of deterring such actions.

II. Agency Law and Section 16(b)

As was indicated earlier, the defendants' activities in *Diamond* are subject not only to state proscription under traditional agency law theory, but also to federal control under Section 10(b) of the Securities Exchange Act of 1934.[47] Furthermore, had the defendants in *Diamond* purchased and sold their securities within a six-month period, the plaintiff could have brought an action under Section 16(b) of the Securities Exchange Act of 1934.[48] Section 16(b) prohibits the retention of short-swing profits resulting from the purchase and sale or sale and purchase of securities of a corporation within a six-month period by officers, directors or 10 percent shareholders of the corporation. Under section 16(b) proof of actual use or knowledge of inside information is not required,[49] and the corporation may recover the insider's profits resulting from the prohibited transactions.

Comparing the cause of action under agency principles with the federal cause of action created under section 16(b), it is obvious that the agency action is applicable to a wider variety of situations. Any agent of a corporation may be liable under agency principles for engaging in transactions in the securities of his corporation on the basis of inside information. Under section 16(b) only officers, directors and 10 percent shareholders are liable for engaging in the prohibited transactions. Moreover, an officer, director or 10 percent shareholder is not liable under section 16(b), even when his transactions are based on inside information, if he holds the securities for six months.[50] Also, to obtain corporate recovery under section 16(b) it is necessary to show both the purchase and sale or a sale and purchase of the securities by the defendant, whereas under the agency theory a single transaction in the securities of the corporation is sufficient to establish liability.

Acknowledging the differences between the agency action and the section 16(b) action, a situation could arise in which an officer or director of a corporation might be subject to liability under both agency principles and section 16(b). The plaintiff must weigh a variety of factors to determine which approach offers the greater likelihood of success. The major difficulty faced by the plaintiff in an agency action is proof of the defendant's knowledge and use of inside information. Section 16(b), however, does not require such proof. On the other hand, under agency theory the plaintiff need only prove that the defendant was an agent of the corporation at the time of the transaction, whereas a section 16(b) plaintiff must specifically prove

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47 15 U.S.C. § 78j(b) (1964). See note 1 supra.

48 15 U.S.C. § 78p(b) (1964). See note 3 supra.

49 2 L. Loss, Securities Regulation 1041 (2d ed. 1961).

50 Id. at 1042.

that the defendant was an officer, director or 10 percent shareholder. Thus, where it is unclear whether the defendant meets the status requirements of section 16(b), it might be advisable to proceed with an agency action if the defendant is an agent of the corporation.

The section 16(b) plaintiff also must show that both the acquisition and the disposition of shares by the defendant constituted a purchase and sale under the Act. Certain transactions, such as a purchase of shares in conjunction with an approved stock option plan, are exempt from section 16(b).[51] Under agency theory the plaintiff need only show a single transaction which was based upon the use of inside information. Also, in an agency action the plaintiff is not restricted by the six-month limitation which is operative under section 16(b). Thus, while section 16(b) presents a relatively unambiguous, objective test for the determination of liability, the scope of the section is limited to a narrower category of individuals and situations than the agency cause of action. The agency action, although it is applicable to a greater number of individuals and situations, presents a more difficult burden of proof, since it involves the proof of subjective factors in order to establish liability.

Aside from these substantive issues, certain procedural considerations might be relevant to a potential plaintiff's choice as to which suit to bring. A section 16(b) action would be brought in a federal court,[52] whereas the agency suit may have to be brought in a state court.[53] Procedural differences between these forums might dictate the choice of action. Of special concern might be the statute of limitations for each action. The statute of limitations for a section 16(b) action is two years,[54] whereas the statute of limitations under agency law, which varies from state to state, may be longer than two years.[55] Perhaps the most important procedural considerations relate to the rules regulating shareholders' derivative suits.[56] A plaintiff bringing a

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[51] These exemptions are set forth in 17 C.F.R. §§ 240.16b-1 to -11 (1968).

[52] The Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (1964), provides in part:

> The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law . . . .

[53] The agency law claim is a cause of action created by state law and would be brought in a state court unless the suit was removed to a federal court on the grounds of diversity or of pendant jurisdiction in conjunction with a § 16(b) action brought by the plaintiffs in addition to the agency suit.

[54] 15 U.S.C. § 78p(b) (1964) provides in part: [N]o suit shall be brought more than two years after the date . . . [defendant's] profit was realized.

[55] In New York, for example, the statute of limitations for the agency action is 6 years. N.Y. Civil Prac. Law § 213 (McKinney 1963).

[56] Both the *Diamond* agency cause of action and the § 16(b) action can be brought by the corporation itself. Since the suit in *Diamond* was brought by a shareholder it is obvious that the law allows a derivative action by shareholders in that situation. Under § 16(b) the shareholder may sue the defendants on behalf of the corporation, but this is not a true derivative action since it is a right granted to them by the statute and not a right they acquire in relation to the existence of a corporate right. Blau v. Oppenheim,

derivative suit in a state court may be required to post security for the suit,[57] whereas a shareholder suing under section 16(b) in a federal court is not required to post security for the suit.[58] In addition, the jurisdiction and venue provisions operative in a section 16(b) suit in a federal court are very broad.[59] Any of these differences may dictate that the plaintiff utilize section 16(b) when its objective requirements have been met.

Thus, if an officer, director or 10 percent shareholder purchases and sells securities in his corporation within a six-month period, section 16(b) is generally the better approach to utilize since it involves an objective determination as to the defendant's liability and the procedural regulations may be more favorable in a federal court. However, the agency approach may be preferable in situations where the plaintiff is unsure whether the objective requirements of section 16(b) have been met. Of course, the agency action represents the only approach when the defendant is an agent but not an officer, director or 10 percent shareholder of the corporation, or when any of the objective requirements of section 16(b) have not been met.

The concurrent existence of federal and state causes of action applicable to the same transaction raises the possibility of double recovery by the corporation. It is submitted that the corporation should not recover twice the amount of profits realized by the defendants, regardless of which action is brought first or whether both are raised simultaneously in a federal court.[60]

If a section 16(b) action is brought subsequent to a successful agency suit in which the corporation has been awarded the defendant's profits, then recovery under section 16(b) by the corporation is barred by Section 28(a) of the Securities Exchange Act of 1934,[61] which limits the total amount recoverable by any person in an action under

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[1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,630, at 95,349 (S.D.N.Y., Feb. 21, 1966).

57 For example, in New York a plaintiff bringing a derivative action may have to post reasonable security for expenses, including attorney's fees, if his holdings of corporate stock do not amount to 5% of any class of stock or a beneficial interest in such amount or have a fair market value of less than $50,000. N.Y. Bus. Corp. Law § 627 (McKinney 1963).

58 Truncale v. Blumberg, [1948-1952 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 90,470 (S.D.N.Y. Oct. 24, 1949).

59 Section 27 of the Securities Exchange Act of 1934 enables the plaintiff to sue the defendant in the district court in the jurisdiction in which the violation occurred, or in any other district in which the defendant can be found or where the defendant transacts business. 15 U.S.C. § 78aa (1964).

60 It is possible that the agency claim could be raised simultaneously with a § 16(b) claim in a federal court under the doctrine of pendant jurisdiction.

61 15 U.S.C. § 78bb (1964) provides in part:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of a judgment in one or more actions, a total amount in excess of his actual damages . . . .

the Act to the actual damages sustained.[62] Assuming that the term "actual damages" in section 28(a) is broad enough to encompass any non-compensatory amount awarded the corporation under section 16(b), then section 28(a) is a bar to such recovery in any section 16(b) action brought subsequent to a successful agency suit. Furthermore, recovery under a section 16(b) action brought subsequent to a successful agency action should be denied because section 16(b) only authorizes recovery of the defendant's "profits." Similarly, such double recovery should also be barred for the same reasons in an agency suit brought subsequent to a section 16(b) decision awarding defendant's profits to the corporation.

Where agency and section 16(b) actions are presented simultaneously in a federal court,[63] the court should make findings of fact and determine the question of liability as to both claims. If the plaintiff is successful on either of the claims he should be entitled to the defendant's profits. However, if the factual findings sustain liability on both claims, plaintiff should still only recover defendant's profits and not twice that amount. The arguments against double recovery outlined above should apply in this situation also to bar recovery in excess of actual damages or defendant's profits.

III. Agency Law and Rule 10b-5

Although the double recovery problem can be easily resolved by a court in a situation which involves a section 16(b) and an agency law violation, the problem of double recovery is less easily resolved where a potential violation of rule 10b-5[64] is involved. The court recognized that a violation of rule 10b-5 existed in *Diamond*.[65] The court stated that there was no doubt that the defendants withheld material information which formed the basis of their transactions, and that as corporate insiders who, on the basis of nonpublic material facts, traded in the securities of their corporation, they violated rule 10b-5.[66] The court, however, avoided any discussion of the effect of a future finding of liability under rule 10b-5 on the defendants or on the corporation's present right to recovery of the defendants' profits. The court noted that no individual or class of individuals had come forward presenting a rule 10b-5 claim before it or any other court, nor had the defendants interpleaded any individual or class of individuals to protect themselves from the possibility of double liability.[67] Thus, the *Diamond* court did not have to decide which individuals are proper rule 10b-5 plaintiffs in such a situation, what effect subsequent rule

62 Meisel v. North Jersey Trust Co., 216 F. Supp. 469 (S.D.N.Y. 1963).

63 See note 60 supra.

64 17 C.F.R. § 240.10b-5 (1964). See note 1 supra.

65 24 N.Y.2d 494, 502, 248 N.E.2d 910, 914, 301 N.Y.S.2d 78, 84 (1969).

66 SEC v. Texas Gulf Sulfur Co., 401 F.2d 833 (2d Cir. 1968).

67 24 N.Y.2d at 504, 248 N.E.2d at 915-16. 301 N.Y.S.2d at 86.

10b-5 liability might have on the present recovery by the corporation, or the problem of possible double liability of the defendants.[68]

Although the *Diamond* court did not have to decide these issues, they will eventually have to be resolved.[69] The identification of the proper rule 10b-5 plaintiff is central to the question whether double recovery should be allowed. The difficulty encountered in determining the proper rule 10b-5 plaintiff in the *Diamond* situation stems from the fact that the securities transactions involved were conducted on the over-the-counter market, thus making it virtually impossible to determine the identity of the purchasers of the shares of stock which were sold by the defendants. These purchasers are the parties actually injured by the defendants' securities transactions and are thus the proper plaintiffs in a rule 10b-5 action. The duty of disclosure imposed on insiders by rule 10b-5 is applicable whether the transactions are conducted face-to-face, over a national securities exchange or on the over-the-counter market.[70]

It is submitted that a careful analysis of the exact duty breached by the defendants will indicate who is an appropriate rule 10b-5 plaintiff in the *Diamond* situation. The rule imposes on insiders in such situations the duty not to trade in the securities of their corporation on the basis of inside information. If the insiders do trade in those securities, they must first publicly disclose all material information relative to their transactions.[71] If they cannot or choose not to make that information public, they must not trade in those securities.[72] A public statement of the material facts satisfies the obligation to make all relevant information available to investors.[73] Thus, the duty that the defendants in *Diamond* breached was one which was owed to the entire investing public.

It might be argued that the defendants ought to be held liable for the losses sustained by all investors who purchased MAI stock during the period of non-disclosure beginning at the time of the insiders' first sale of stock. This argument must be rejected since it merely assumes the necessary causal connection between the duty breached and the injury suffered.[74] That is, it assumes that if the information had been

68 Id.

69 The *Diamond* court did take note of the fact that these issues are presently involved in litigation in the federal courts, and that one case, SEC v. Texas Gulf Sulfur Co., 401 F.2d 833 (2d Cir. 1968), is particularly involved with these yet unresolved questions as to who is the proper rule 10b-5 plaintiff in such a situation and what are the appropriate remedies.

70 The purpose of rule 10b-5 is to prevent fraud and deceit in connection with the purchase and sale of securities. The individuals who purchased the shares which the defendants in *Diamond* sold on the basis of nonpublic information were the victims of the type of fraud and deceit Congress intended to protect against, and are thus the proper 10b-5 plaintiffs. They would certainly be so if the transaction were conducted face-to-face. SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 847-48 (2d Cir. 1968).

71 Id. at 848.

72 Id.

73 Id. at 854.

74 In Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946), the

publicly disclosed none of the present buyers would have purchased MAI securities. This assumption is contrary to practical experience. At best it would be valid as to some or most of the investors, but certainly not to all. Furthermore, the acceptance of this assumption might well subject the defendants to the possibility of liability for millions of dollars of damages. Such a tenuous causal connection is clearly not commensurate with this extensive liability.

This extreme result may be avoided by viewing the duty imposed by rule 10b-5 as requiring the insider to refrain from trading in the securities of his corporation on the basis of inside information rather than as a duty to disclose the information when he does trade. If the duty created by the rule is so viewed, liability for violation of the duty is limited to the extent to which the insider does trade in the securities of his corporation. This view is supported by the fact that non-disclosure without trading by the insider imposes no liability upon the insider for losses sustained by any purchaser of the stock during the period of non-disclosure.[75] The insider's liability arises only when he trades in the security on the basis of the non-disclosed information. Thus, the persons injured by the insider are the persons who purchased the shares he sold, and not every purchaser of shares during the period of non-disclosure.

Assuming this to be the correct interpretation of the duty breached, the problem remains of identifying the purchasers of the shares sold by the insiders. While precise identification is impossible, at least the class of individuals purchasing the stock on the day or days on which the defendants sold their stock may be identified. It would seem equally as valid to assume that all of these individuals acquired some of the shares that the defendants sold as to assume that one or a few of these individuals acquired all of the defendants' shares. If one accepts the assumption that each of the purchasers acquired some of the defendants' shares, then it should be presumed that the percentage of the defendants' shares acquired by each individual is equal to the percentage which each individual's daily purchase represents of the total number of shares purchased on those days.[76] That is, each individual who purchased shares of MAI stock on the days

court stated that a violation of rule 10b-5 constitutes a tort. Thus the basic tort doctrine, that in order for liability to exist the defendant's action must have a reasonable causal connection to the injury suffered by the plaintiff, W. Prosser, The Law of Torts 240 (3d ed. 1964), should apply to a 10b-5 case.

[75] SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 848 (2d Cir. 1968).

[76] For example, if an individual purchased 100 shares of MAI stock on a day on which the defendants in *Diamond* sold 1,000 shares and the total number of MAI shares purchased on that day was 100,000, then the percentage of the defendants' 1,000 shares that the individual is presumed to have purchased on that day is computed as follows:

$\frac{100}{100{,}000} = 1\%$ — the individual purchased 1% of all the shares of MAI stock purchased on that day

$1{,}000 \times .01 = 10$ — the individual is presumed to have purchased 10 shares from the defendants.

on which the defendants sold their stock should be presumed to have been injured in proportion to the number of shares his purchase represents of the total traded. Thus, the appropriate remedy for these rule 10b-5 plaintiffs is a pro rata distribution among them of the defendants' profits.

If the duty imposed upon the defendants in *Diamond* by rule 10b-5 is such as to prevent them from trading in the securities of their corporation on the basis of inside information, their breach of duty is measurable by the extent to which they did trade in such securities on the basis of inside information. The injury they caused by the breach is the profit they derived from the sale of their shares, and the appropriate remedy is the pro rata distribution of those profits to the class of individuals who purchased MAI stock on the days on which the defendants sold their shares.

Having defined the proper parties to bring a rule 10b-5 action in *Diamond* and the relief available to them, the final issues to be discussed are the effect of a subsequent rule 10b-5 decision on a previous agency or section 16(b) suit in which the corporation was awarded the defendant's profits, and the effect on a subsequent agency or section 16(b) suit of a previous rule 10b-5 judgment in which the plaintiffs recovered. It is submitted that the defendants should not incur double liability under these causes of action, and that the conflict should be resolved by determining which plaintiff has the higher claim to the defendants' profits.

As noted earlier, both the agency and the section 16(b) causes of action prescribe the same remedy—corporate recovery of the defendant's profits. Thus, if the rule 10b-5 suit were settled first, in favor of the plaintiff, then arguably there would be no profits to be recovered in the second suit.[77] The dismissal of an agency or section 16(b) suit which is brought subsequent to a rule 10b-5 suit in which the plaintiff has been granted relief is not objectionable in light of the fact that the recovery of those profits by the rule 10b-5 plaintiff effectuates the policy of the agency and section 16(b) actions in that it deters deceptive conduct on the part of officers, directors or 10 percent shareholders of a corporation by removing the profit incentive for such actions. The purposes of the agency and section 16(b) actions are effectuated just as well by the rule 10b-5 plaintiff's recovery of those profits as by the corporation's recovery of them. Furthermore, since the recovery by the corporation in an agency or section 16(b) action is primarily for the purpose of deterring specific conduct on the part of certain individuals, rather than for compensating an injured party, the dismissal of the subsequent agency or section 16(b) action does not deny an injured party compensation for damages suffered.[78]

77 See p. 510 supra.

78 The recovery of the defendants' profits is in no way a measure of the damages suffered by the corporation in a *Diamond* situation. Section 16(b) is expressly a deterrent provision. Similarly the *Diamond* cause of action is based upon a deterrent policy. 24 N.Y.2d at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 81.

There seems to be no reason for not barring subsequent agency or section 16(b) recovery by a corporation when a rule 10b-5 plaintiff has already effectuated the goals of those provisions.

A more difficult problem exists where the corporation has previously recovered the defendant's profits in an agency or section 16(b) suit and subsequently a rule 10b-5 action is brought in which the plaintiff establishes his claim. Holding the defendant liable for both claims is unacceptable since he would only be liable for one claim if the suits had been instituted or settled in reverse order. It is, of course, equally unacceptable to deny a 10b-5 plaintiff's claim since his claim represents the actual losses he suffered as a result of the defendant's transactions. It is submitted the rule 10b-5 plaintiff has a higher claim to the defendant's profits than the corporation, because those profits represent the rule 10b-5 plaintiff's actual losses whereas the corporation is only awarded the profits so as to deter similar insider transactions.[79] If one accepts the premise that a rule 10b-5 claim represents a superior claim to the defendant's profits than the corporation's claim under agency law or section 16(b), then where the corporation has previously recovered under agency law or section 16(b), a rule 10b-5 plaintiff who has successfully brought suit against the defendant should be allowed to reach his proportion of the profits recovered by the corporation by order of the court.[80]

To facilitate the future recovery of rule 10b-5 plaintiffs in the *Diamond* situation, the court in which the agency or section 16(b) suit is being litigated, if it finds that actions under rule 10b-5 may be commenced, should award defendant's profits to the corporation on the condition that they be held in trust subject to the claims of any future rule 10b-5 plaintiff who successfully establishes his claim in a federal court.[81] If no rule 10b-5 actions are commenced within the

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79 The proposition that the rule 10b-5 claim is superior to the agency or § 16(b) claim was recognized and supported by the *Diamond* court. In discussing the possibility of double liability the court stated: "It is not unusual for an action to be brought to recover a fund which may be subject to a superior claim by a third party." 24 N.Y.2d at 504, 248 N.E.2d at 915, 301 N.Y.S.2d at 86.

80 Up to this point it has been argued that the corporation recovers the defendant's profits purely as a deterrent measure to eliminate the incentive for breaches of fiduciary duty. It was this deterrent character of the award which supports the position that the 10b-5 claim is superior in that it is compensatory in character. It should be noted, however, that the agent's breach of his fiduciary duties may indeed result in injury to the corporation and, in that case, the corporation should be allowed to recover for any specific injuries it sustains completely apart from its recovery of the defendant's profits.

81 The trust award suggested in the present case, of limited life and for the benefit of a class of potential rule 10b-5 plaintiffs, is analogous to the traditional constructive trusts created as a remedy in equity where traditional forms of relief are unavailable. Osin v. Johnson, 243 F.2d 653 (D.C. Cir. 1957). The basic difference between the traditional constructive trust and the trust suggested in the present case is that in the former the trust is usually imposed upon a wrongdoer who will be unjustly enriched if allowed to keep the corpus of the trust. Id. Although the corporation in the present case is not a wrongdoer, it would be unfair and unjust to allow its recovery to bar the rule 10b-5 plaintiffs' recovery in light of the superior nature of the latters' claim.

period provided for by the applicable statute of limitations, then the corporation should take full title to the funds. If a rule 10b-5 suit were brought within that time, then the duration of the trust should automatically be extended until the rule 10b-5 action is resolved.

CONCLUSION

Although the court in *Diamond* based its holding on the erroneous premise that any use of confidential information acquired by an officer or director of a corporation in the course of his duties is per se a breach of the officer's or director's fiduciary duty, the result in the case is nevertheless correct. The proper reason for upholding the defendants' liability in *Diamond* is that the defendants placed themselves in a position of conflict of interest with the corporation. Their personal use of the information in selling MAI securities, although beneficial to them, compromised the image and reputation of the corporation and therefore constituted a breach of their fiduciary duty.

It has been shown that it is possible for an officer or director of a corporation, by imprudent transactions in the securities of his corporation, to violate not only the fiduciary duty owed to his corporation but also section 16(b) and rule 10b-5 simultaneously. Each violation gives rise to a distinct claim for the profits derived by the insider from the prohibited transactions. However, triple liability should not be imposed upon the defendant; the insider should be liable only to the extent of the profits derived from the transactions. The threat of double recovery by the corporation under agency law and section 16(b) is eliminated by Section 28(a) of the Securities Exchange Act of 1934 which limits the total recovery of any individual entitled to sue under the Act to his actual damages,[82] and by the fact that both section 16(b) and agency theory limit recovery of the "profits" of the defendant.[83] There is likewise no possibility of double liability created by the concurrent existence of agency law, section 16(b) and rule 10b-5 actions, since plaintiff's claim to the defendant's profits under rule 10b-5 is superior to the claim of the corporation under agency law or section 16(b). Thus, if a rule 10b-5 claim is settled prior to an agency or section 16(b) suit, the subsequent suit should be dismissed since there are no "profits" to be recovered in the latter suits, and since the deterrent policy which those latter suits were intended to enforce has already been effectuated by the recovery under rule 10b-5. In the reverse situation, where a successful rule 10b-5 claim is brought subsequent to the corporation's recovery in an agency or section 16(b) suit, the rule 10b-5 plaintiff would be allowed to reach the profits recovered by the corporation because his claim represents his actual damages, and is therefore superior to that of the corporation which recovered the funds for the purpose of deter-

[82] See pp. 509-10 supra.

[83] See p. 510 supra.

ring such actions on the part of corporate agents rather than as compensation for any injury suffered.

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